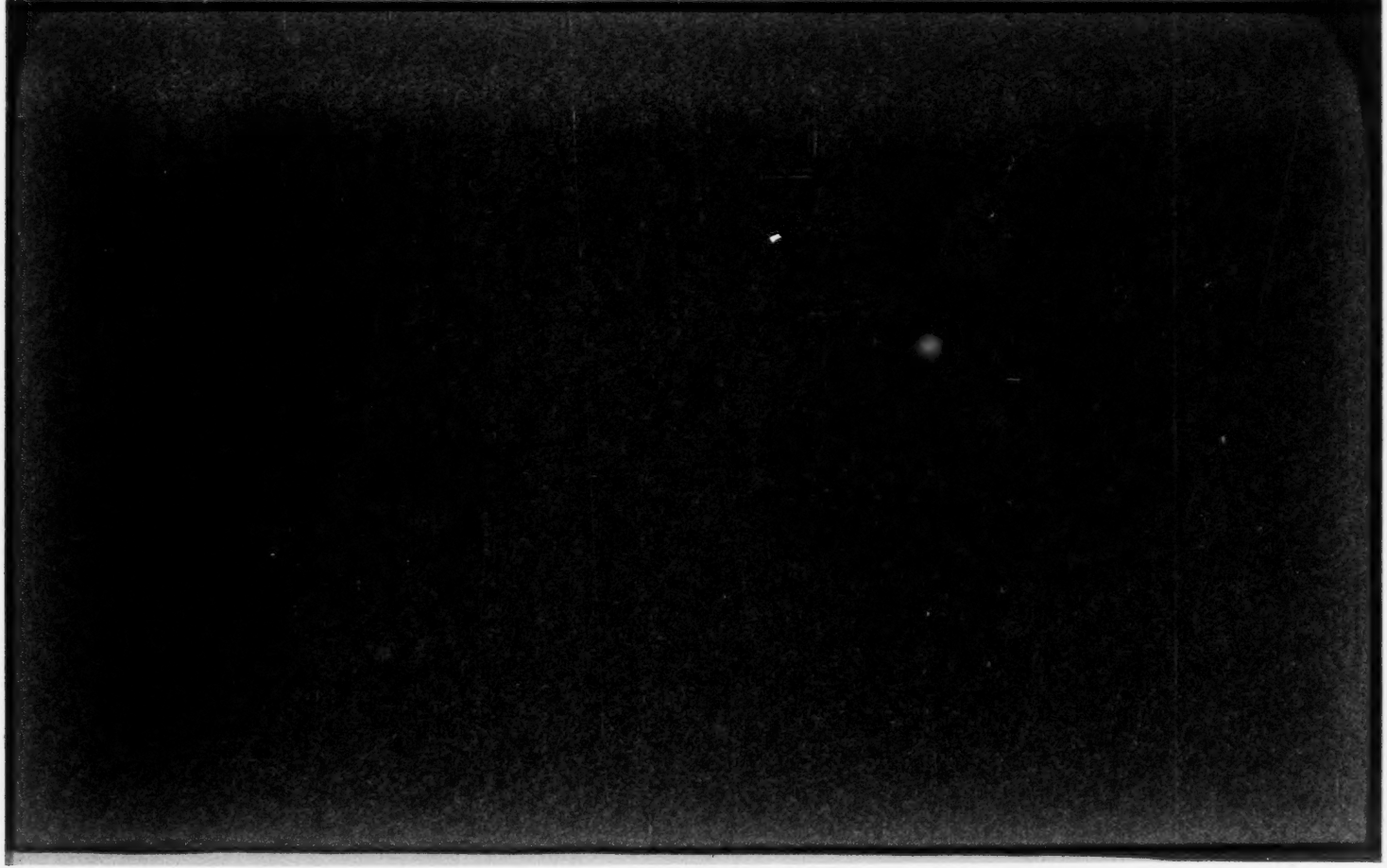

INDEX

CITATIONS

495960 42——1

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 512

STANDARD OIL COMPANY (AND AFFILIATED SUBSIDIARIES), PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 319–361) is reported in 43 B. T. A. 973. The opinion of the Circuit Court of Appeals (R. 391–408) is reported in 129 F. 2d 363.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 12, 1942. (R. 408.) A petition for rehearing was denied August 5, 1942.

(R. 418.) The petition for a writ of certiorari was filed November 4, 1942, and the jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer was properly denied any deduction under Section 23 of the Revenue Act of 1928 for the sum paid the United States in settlement of a suit based on the conversion of oil acquired from the lessee of the Teapot Dome.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and regulations are set forth in the Appendix, *infra,* pp. 21–23.

STATEMENT

The facts found by the Board of Tax Appeals may be summarized, as follows:

During the calendar year 1930, the taxpayer was the "common parent corporation" of an "affiliated group" under Section 141 of the Revenue Act of 1928 and Article 2 of Treasury Regulations 75, issued pursuant thereto. (R. 321, 322.) On September 22, 1930, the taxpayer acquired all of the stock of the Stanolind Crude Oil Purchasing Company (referred to herein as Stanolind), which thus became one of the affiliated group. (R. 326.) Stanolind filed a separate return for the period January 1 to September 21, 1930, showing a substantial net loss, produced mainly by the

deduction here in issue. The taxpayer has claimed a carry-over of this net loss under Section 117 (a) of the Act (Appendix, *infra*). (R. 345–346.)

Stanolind was incorporated on February 5, 1921 (R. 321), and was known until September 22, 1930, as the Sinclair Crude Oil Purchasing Company (R. 321, 327). During this period half of Stanolind's stock was owned by the Sinclair Consolidated Oil Company and half by the taxpayer. (R. 326.) The chairman of the board of directors of Sinclair Consolidated Oil Company was Harry F. Sinclair. (R. 332.)

On February 28, 1922, Sinclair incorporated the Mammoth Oil Company. Its stock was issued to him for $1,000 and his services in procuring for Mammoth on or about April 7, 1922, what purported to be an oil and gas lease for Mammoth from the United States on certain Government-owned lands in the State of Wyoming known as Naval Petroleum Reserve No. 3 and commonly called "Teapot Dome." Shortly thereafter Sinclair Consolidated Oil Company acquired the stock of Mammoth. (R. 326.)

The lease was signed on behalf of the United States by Albert B. Fall, then Secretary of the Interior, and Edwin Denby, then Secretary of the Navy. It was signed on behalf of Mammoth by H. F. Sinclair, president. It purported to grant Mammoth the exclusive right to take and dispose

of the oil and gas from the land covered so long as it was produced in paying quantities. It also purported to give Mammoth the right to construct tanks and other operating facilities on the leased lands. (R. 327.)

On February 9, 1923, the same parties entered into what purported to be a supplemental agreement concerning, among other things, certain storage facilities to be provided by Mammoth, the operation of the purported lease, and the disposal of the Government's royalty oil. Stanolind was not a party either to the lease or supplemental agreement, and it was not mentioned in either instrument. (R. 327.)

On October 24, 1922, Stanolind entered into a three-party contract with Mammoth and another subsidiary of the taxpayer. The agreement recited, *inter alia,* that the parties desired to cooperate in a program to extend the market for crude oil produced in the State of Wyoming; and that Mammoth owned and operated the lease on Naval Reserve No. 3, commonly called "Teapot Dome." Under the agreement, Stanolind agreed to purchase the first oil to be produced by Mammoth from the Teapot Dome to an amount not exceeding 30,000,000 barrels. (R. 327–330.)

On March 13, 1924, the United States instituted an action in the District Court of the United States for the District of Wyoming to cancel the Teapot Dome lease and set aside the supple-

mental agreement. Stanolind was named as one of the parties defendant. The complaint alleged that Stanolind claimed to hold certain rights derived from defendant Mammoth Oil Company and maintained certain oil storage tanks on the land covered by the lease in question. The bill prayed for an adjudication of the rights of the defendants in the premises and a decree against Stanolind in relief of the plaintiff's right of possession. (R. 332–333.) In its answer Stanolind denied that it was a trespasser and "for separate and further defense" alleged such facts as it thought necessary to establish its ownership in and right to remove the 17 tanks located on the Teapot Dome lease. (R. 334.)

On the day the bill of complaint was filed, receivers were appointed for the property covered by the lease, excluding the oil storage tanks owned by Stanolind. Prior to the receivership, Stanolind, pursuant to its contract with Mammoth, obtained 1,430,024.70 barrels of oil from lands covered by the Teapot Dome lease. For this oil it paid Mammoth the sum of $2,167.591.26. (R. 330, 333.)

On June 19, 1925, the District Court handed down its decision in the Wyoming suit, *United States* v. *Mammoth Oil Co.*, 5 F. 2d 330, upholding the validity of the lease. The District Court's decision was reversed and remanded by the Circuit Court of Appeals for the Eighth Cir-

cuit on September 28, 1926. 14 F. 2d 705. The Circuit Court of Appeals found that "each of the appellees is a *mala fide* trespasser" and held that the lease and agreement were obtained by fraud and corruption. It directed the District Court to cancel the lease, enjoin the defendants from further trespassing on the land involved and require an accounting on the part of the Mammoth Oil Company for all oil taken under the lease. (R. 334.)

The opinion of the Circuit Court of Appeals was affirmed by the Supreme Court on October 10, 1927. *Mammoth Oil Co.* v. *United States,* 275 U. S. 13, 55. The Supreme Court held not only that the execution of the lease and agreement was fraudulent, but also that there was no authority in law for their execution. In adjudicating the rights of Stanolind in the premises, the Court said (pp. 53–54, 55):

> The lease gave the Mammoth Company the right to construct tanks and other operating facilities on the reserve. In January, 1923, the petitioner, Sinclair Crude Oil Purchasing Company [Stanolind], bought from that company the tanks already constructed and others being built thereon. It used them to store Salt Creek royalty oil that it bought from the Government. It claims that it relied on the validity of the lease and became the owner of the tanks as licensee and grantee of the lessee and entitled to maintain them in all respects as

the lessee was entitled to do under the lease. It contends that the Circuit Court of Appeals erred in directing it to be restrained from further trespassing upon the reserve, and that in any event it should be given opportunity to remove its property. But the Purchasing Company is presumed to have known that no law authorized the making of any such lease. The existence of that arrangement for the exhaustion of the reserve was calculated to excite the apprehensions of one considering such a purchase and put him on his guard rather than to give assurance of safety. The use of such tanks to take oil from the reserve was a part of the illegal scheme. Moreover, the Purchasing Company was owned half and half by the Sinclair Consolidated Oil Corporation and the Standard Oil Company of Indiana. Sinclair was chairman of the board of the former, and Stewart held like position in the latter. Shortly before the Purchasing Company bought the tanks, these chairmen acted for and controlled it in respect of most important transactions. That and other disclosed circumstances are sufficient to impute to it Sinclair's knowledge of the conspiracy to defraud by which the lease was obtained. It is clear that, in respect of the use and removal of these tanks, the Purchasing Company is in no better position than the Mammoth Company would have occupied, if it owned them.

* * * * *

195960—42—2

> The tanks, pipe line and other improvements put upon the reserve for the purpose of taking away its products were not authorized by Congress. The lease and supplemental agreement were fraudulently made to circumvent the law and to defeat public policy. No equity arises in favor of the lessee or the other petitioners to prevent or condition the granting of the relief directed by the Circuit Court of Appeals. Petitioners are bound to restore title and possession of the reserve to the United States, and must abide the judgment of Congress as to the use or removal of the improvements or other relief claimed by them. *Pan American* case, *supra*, p. 510.

Pursuant to the mandate from the Supreme Court the District Court on December 29, 1927, entered a decree enjoining the defendants from trespassing on the land and from claiming any right, title, or interest to any improvements thereon or from removing any of the improvements. In the final decree in the Wyoming suit Mammoth was ordered to pay the United States the sum of $2,294,597.74 as the value of oil and other petroleum taken together with interest thereon of seven per cent. Only $3,509.19 was paid on this judgment. (R. 336.)

Thereafter the United States brought an action against Stanolind in the United States District Court for the District of Delaware for the conversion of the 1,430,024.70 barrels of crude oil

which Stanolind had obtained from Mammoth under the contract of October 24, 1922. (R. 336.) In addition to the value of the oil and seven per cent interest thereon the declaration in the Delaware suit claimed exemplary and punitive damages on the ground that Stanolind had acquired the oil fraudulently. (R. 338.)

After the pleadings were in, Stanolind offered to terminate the case by paying the sum of $2,906,484.32. This figure represented the value of the oil plus interest at seven per cent, less the estimated value of the 17 oil tanks erected by Stanolind on the Teapot Dome land. Owen J. Roberts and Atlee Pomerene, special counsel for the United States, recommended approval of this settlement to Congress and it was thereafter approved by a joint resolution. (R. 339, 340–344.) Subsequently upon stipulation filed by counsel for the United States and Stanolind judgment for the amount of the settlement was entered in the case. The judgment was paid by Stanolind on June 2, 1930, from funds previously placed in escrow. (R. 344.)

At the time of the judgment, Stanolind's books carried an account payable to Mammoth in the amount of $4,618.86. This amount was credited to surplus, and the amount of $2,906,484.32 was charged to surplus. The effect was a net charge to surplus of $2,901,865.46. (R. 344–345.)

Stanolind filed a separate return for the period January 1 to September 21, 1930, on which it

reported a net loss of $3,715,123.57. In arriving at this net loss, it deducted the aforesaid figure of $2,901,865.46. (R. 345.) This net loss was carried over in the consolidated return.

In disallowing a deduction for any part of this payment, the Board of Tax Appeals found (R. 346):

> 44. The lease of April 7, 1922, and the supplemental agreement of February 9, 1923, were executed without warrant or authority of law and contrary to the policy of the United States to conserve its petroleum resources. The lease and agreement were fraudulent. Stanolind is charged with notice that those agreements were executed contrary to law, and with knowledge of the fraud perpetrated. Stanolind acted in bad faith and as a *mala fide* trespasser upon the Government-owned lands in acquiring the 1,430,024.70 barrels of oil in question.

The Board based this finding on the conclusion that the Wyoming action was *res judicata* of Stanolind's bad faith.

The Board held that in light of this finding it would be against public policy to allow any deduction. (R. 360.) It was found unnecessary to determine whether the payment otherwise might be designated as an expense, a loss, or a bad debt, or in part as interest on indebtedness, under the statutory provisions for deductions contained in Subsections (a), (b), (f), or (j) of Section 23 of the Revenue Act of 1928 (Appendix, *infra*).

The Circuit Court of Appeals sustained the Board on both grounds of its decision.[1] The court concluded (1) that the Board's finding of bad faith was supported both by the prior decision in the Wyoming case (R. 398–399) and by the inferences otherwise to be drawn from the record (R. 402–405), and (2) that public policy therefore properly forbade the allowance of any deduction (R. 402).[2]

ARGUMENT

I

The circuit courts of appeals have consistently disallowed any deductions for fines or penalties paid by a taxpayer as a consequence of statutory

[1] There was a second issue in the case concerning the depreciation of patents held by the taxpayer upon which review has not been sought.

[2] The court also expressed the view that, while it was unnecessary to consider the question, any claim which Stanolind might have had against Mammoth for breach of warranty did not provide a basis for a bad debt deduction (R. 400), but that if a deduction was allowable, it would fall under the heading of a bad debt, rather than of an ordinary and necessary business expense or a loss (R. 402). Like the Board, the court did not consider whether, if it were not for the public policy consideration, the portion of the payment representing interest would be deductible as interest on indebtedness under Section 23 (b).

Neither the Board nor the court passed on the Government's further contention that if the deduction was allowable, it could not be carried over as part of the net loss under Section 117(a)(1) since it was not "attributable to the operation of a trade or business regularly carried on by the taxpayer".

violations. *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. 2d 178 (C. C. A. 2d) (violation of state price-fixing laws); *Great Northern Ry Co.* v. *Commissioner,* 40 F. 2d 372 (C. C. A. 8th), certiorari denied, 282 U. S. 855 (violation of federal statute and regulations in operation of railroad); *Chicago, R. I. & P. Ry. Co.* v. *Commissioner,* 47 F. 2d 990 (C. C. A. 7th), certiorari denied on other points, 284 U. S. 618 (violation of Safety Appliance Act); *Tunnel R. R.* v. *Commissioner,* 61 F. 2d 166, 173–174 (C. C. A. 8th), certiorari denied, 288 U. S. 604 (violations of Safety Appliance Act and the Twenty-Eight Hour Live Stock Act)[3]; cf. *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. 2d 878 (C. C. A. 2d); *Gould Paper Co.* v. *Commissioner,* 72 F. 2d 698 (C. C. A. 2d). The decision below applies the same rule respecting compensation paid the Government by a taxpayer who, it was found, converted public property to its own use in circumstances constituting bad faith.

The controlling consideration in the cases cited is that the taxpayer had engaged in a course of conduct which constituted a wrong against the Government, for which it had been compelled to make compensation. The courts have taken the view that it would be against public policy indirectly to

[3] The English courts have reached similar results in applying the cognate provisions of the British Income Tax Acts. See *Inland Revenue Commissioners* v. *Von Glehn,* [1920] 2 K. B. 553; *Inland Revenue Commissioners* v. *Warnes & Co.,* [1919] 2 K. B. 444.

sanction the violation by allowing a tax deduction for the amount of the fine or penalty imposed. *Burroughs Bldg. Material Co.* v. *Commissioner, supra,* p. 180. It would be outside the reasonable intention of the Congress to allow the taxpayer "any advantage, directly or indirectly, or any reduction, directly or indirectly, of these penalties." *Great Northern Ry. Co.* v. *Commissioner, supra,* p. 373.

In the instant case, the ultimate question is the same, and the same considerations apply with even greater force. Stanolind acted directly to the injury of the Government. It entered into the agreement with Mammoth in bad faith, charged with notice that Mammoth's lease from the Government was executed contrary to law and with knowledge of the fraud perpetrated. It participated in a violation of the established policy of the Government for the conservation of naval oil, fraudulently converting to its own use property thus held for the benefit of the public. It would be as violative of public policy indirectly to sanction such conduct by allowance of a deduction for the payment made in restitution to the Government, as it would be to allow a deduction for fines paid for the violation of regulatory statutes. Congress did not intend that a taxpayer, which had been compelled in such circumstances to compensate the Government for conversion of its property, should be enabled, through abatement of

its taxes, to recover a portion of the funds paid.[4]

Moreover, at the last Term the Court sustained the validity of regulations providing that lobbying expenses were not deductible as "ordinary and necessary" expenditures. *Textile Mills Corp.* v. *Commissioner,* 314 U. S. 326. The Court held that the rule-making authority might employ the general policy against lobbying activity in segregating non-deductible expenses. Similarly, we submit, comparable policy considerations may properly be taken into account by the Commissioner, the Board of Tax Appeals, and the courts in determining the scope of the statutory deductions.

The decision on this point, therefore, is in accord with the decided cases. The Court, as we have noted, has denied certiorari on the question as it was presented in the *Great Northern* and *Tunnel* cases, *supra.* No conflict has since arisen.[5] We submit that no occasion now exists for a review of the question upon the peculiar facts of the instant case.

---

[4] It should be observed, moreover, that these considerations would support the decision below even in the absence of a finding of bad faith. All of the cases, which we have cited, concerned violations of mere regulatory provisions; none involved any element of bad faith.

[5] There is clearly no inconsistency, as the taxpayer asserts (Pet. 18), between this decision and the allowance of a deduction for payments made in satisfaction of a private judgment. Treasury Regulations 75, Article 342; *Helvering* v. *Hampton,* 79 F. 2d 358 (C. C. A. 9th). The court in the *Hampton* case observed the distinction "between the defense

II

There is likewise no occasion for review of the action of the court below in sustaining the Board's finding that Stanolind acted in bad faith.[6] (See Statement, *supra*.) The decision was correct, and there is no conflict. Resolution of the issue presented, whether it be regarded as one of fact or

---

of offenses *against the government*, of which governmental policy prohibits consideration as ordinary incidents of a business, and defending *private wrongdoing* in the course of business, the cost of which is ruled deductible" (p. 360).

The taxpayer also asserts a conflict with a number of cases, most of which simply support the general proposition that when the Government enters the courts as a litigant, it is subject to many of the rules governing private individuals. (Pet. 18.) The proposition, however, is obviously beside the point. Significant, rather, is the fact that in *Pan American Co.* v. *United States*, 273 U. S. 456, 508–509, sustaining cancellation of the lease of the California reserves companion to the Teapot Dome lease, the Court emphasized that in this type of action the United States did not stand on the same footing as an individual.

[6] As we have indicated, the Government also argued below that irrespective of the public policy issue and the finding of bad faith, the taxpayer had not established Stanolind's right to a deduction under any one of the statutory provisions involved, namely, Subsections (a), (b), (f) or (j) of Section 23 of the Revenue Act of 1928. It was further argued that in any event the deduction sought could not properly be carried over as part of a net loss under Section 117 (a) of the Act. It is unnecessary to elaborate upon these arguments here. The questions would be before the Court, however, if certiorari were granted.

By the same token, there is likewise no need to consider in detail the taxpayer's contention that the Government's position is inconsistent with the Commissioner's acquiescence in *Davis* v. *Commissioner*, 46 B. T. A. 663, permitting a de-

one of mixed fact and law, turned solely upon the peculiar facts of the instant case.

1. The Board's finding, as we have stated, was based upon its conclusion that the Wyoming action was *res judicata* of the issue. Since the actions were between the same parties (see *Sunshine Coal Co.* v. *Adkins,* 310 U. S. 381, 402–403), the question is whether the prior proceeding included a determination that Stanolind had acted in bad faith and as a *mala fide* trespasser.

In the Wyoming case Stanolind, as a defendant, asserted that even if Mammoth's lease from the Government was invalid, Stanolind was entitled as a third party purchaser to continue its oil storage tanks upon the property and in the alternative to remove them. (R. 212–214, 272–273, 283–284.) Its position was dependent upon its good faith. But in reversing the District Court's judg-

---

duction as interest paid on an indebtedness for that portion of a settlement of a tax liability, including principal, penalty and interest, which consisted of interest. (Pet. 17.) The issue in that case was whether the interest payment was separable interest or part of a lump sum compromise. Since the taxes, exclusive of penalties, would have been payable irrespective of the taxpayer's wrong-doing, the interest to that extent did not result from the taxpayer wrong-doing. To the extent the interest may have been computed on the penalties it is significant that Section 294 (b) of the Revenue Act of 1936 provides that "there shall be collected as part of the tax, *interest* upon the unpaid amount [including fraud penalties] at the rate of 6 per centum per annum." (Italics supplied.) While the question is not free from doubt, this may indicate a congressional intention that interest on fraud penalties is to be treated as interest generally.

ment for the defendants, the Circuit Court of Appeals held that Stanolind was a *mala fide* trespasser on the Government lands, and that therefore it was entitled to no protection for its improvements; it directed the District Court to enjoin the defendants from trespassing on the land. *United States* v. *Mammoth Oil Co., supra,* 14 F. 2d, at 733.

In the proceedings before this Court, Stanolind specified as errors the Circuit Court of Appeals' holding that it was a trespasser *mala fide* on the land, and denial of its right to remove the oil storage tanks which "it had in good faith purchased and constructed thereon." (R. 290.) This Court sustained the Circuit Court of Appeals, holding, in an opinion of which the relevant portions have been quoted in the Statement, *supra,* pp. 6–8, that Stanolind was presumed to know that Mammoth's lease was unauthorized, and that the facts were sufficient to impute to it Sinclair's knowledge of the conspiracy to defraud. 275 U. S. 13, 54.

2. The taxpayer's contention that this decision was not *res judicata* as to Stanolind's bad faith because the litigation concerned the *tanks* rather than the *oil* (Pet. 14–16) is an ingenious but unpersuasive refinement. The trespass on the lands, the erection of the tanks, and the taking of the oil, were all integrated parts of the same illegal scheme. The fact that a different *res* is involved does not prevent the application of the doctrine of *res judicata* where the same issue is presented.

Beloit v. *Morgan,* 7 Wall. 619, 622; *Bissell* v. *Spring Valley Township,* 124 U. S. 225; *New Dunderberg Min. Co.* v. *Old,* 97 Fed. 150 (C. C. A. 8th).

The taxpayer also argues that the consent judgment entered in the subsequent Delaware action against Stanolind constituted a determination that Stanolind had not acted in bad faith. (Pet. 11–13.) This judgment, however, was entered pursuant to a settlement, proposed and effected after Stanolind's bad faith had been adjudicated in the Wyoming action. In this settlement, each side made concessions in order to terminate the litigation. The District Court's judgment, entered upon this settlement, was not a judicial *determination* that Stanolind had acted in good faith. And there is no sound basis for a conclusion that the Government, by agreeing to the compromise, otherwise committed itself to any such proposition binding upon it here.

3. There is also ample evidence to support the Board's determination of bad faith aside from the decision in the Wyoming case. The relationship between Stanolind, Sinclair, and Mammoth, which appears of record, was observed by this Court in the Wyoming opinion. Even apart from this, the sequence of events in the development of the Teapot Dome scandal alone shows the impossibility of regarding Stanolind as an innocent party.

Considerably prior to Stanolind's execution of the oil purchasing contract with Mammoth, charges had been made publicly that the Teapot

Dome leases were fraudulent and in violation of statutes establishing a long-standing policy for the conservation of the nation's oil resources. *E. g.*, Cong. Record, Vol. 62, Part 6, pp. 6042–6050. On April 29, 1922, six months prior to Stanolind's contract with Mammoth, the Senate of the United States, acting on these charges, adopted a resolution by unanimous vote initiating a formal investigation. S. Res. 282, Cong. Record, Vol. 62, Part 6, p. 6097.[7] On June 3, 1922, Secretary of the Interior Fall's answer to the inquiry of the Senate was sent in. S. Doc. No. 210, 67th Cong., 2d Sess. On June 5, 1922, the resolution authorizing the investigation was implemented by an amendment which, *inter alia,* conferred subpoena powers upon the committee. S. Res. 294, Cong. Record, Vol. 62, Part 8, p. 8140. The matter was given the widest publicity.[8] Four months later and directly in the face of these public charges and the Senate's formal investigation Stanolind entered into its contract with Mammoth for its participation in the exploitation of these resources.

---

[7] The resolution authorized the Committee on Public Lands and Surveys (p. 6041):

"* * * to investigate this entire subject of leases upon naval oil reserves, with particular reference to the protection of the rights and equities of the Government of the United States and the preservation of its natural resources, and to report its findings and recommendations to the Senate."

[8] See *e. g.*, N. Y. Times, May 7, 1922, Sec. VII, p. 1; Literary Digest, Vol. 73, No. 8, p. 14 (May 20, 1922); N. Y. Times, August 26, 1922, p. 4, col. 4.

The only conclusion to be drawn from these facts is that Stanolind was at least put upon warning of the invalidity of the lease, and that it must be charged with knowledge of the wrongful character of the transaction. That conclusion has been reached by the Circuit Court of Appeals for the Eighth Circuit and this Court in the Wyoming case, and the court below in the instant case. We submit that further litigation of the issue is uncalled for.

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,

CHARLES FAHY,
Solicitor General.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

SEWALL KEY,
SAMUEL H. LEVY,
WILLARD H. PEDRICK,
Special Assistants to the Attorney General.

NOVEMBER, 1942.